Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Allocation of Costs Associated with	)	CC Docket No. 96-112
Local Exchange Carrier Provision of	)	
Video Programming Services	)	

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To the Commission:

Reply Comments

BELLSOUTH CORPORATION AND
BELLSOUTH TELECOMMUNICATIONS, INC.

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June 12, 1996

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Summary

This proceeding has little to do with protecting telephone customers against cross-subsidy. Price cap regulation has already achieved that objective. Allocation of joint costs is not necessary to prevent cross-subsidy. The Notice implicitly acknowledges this fact when it attempts to justify allocation of joint costs as a means of assigning some benefit of scope economies to telephone customers and of compensating for the imperfections of cost allocations.

This proceeding fails to focus or seek comments on the potential impact of cost allocations on important public policies that the Commission is responsible for promoting: competitive entry and infrastructure deployment. If the Commission continues to approach this proceeding from the narrow perspective of regulatory accounting and allocation issues, it will risk doing substantial harm to consumers' substantial interest in competitive entry and infrastructure deployment.

LECs are facing difficult decisions regarding whether to invest their substantial, but finite, capital in advanced broadband networks or in other ventures. Even if risks are not increased by administrative cost allocations, market conditions may make other investments more attractive. Consistent with its obligations under the 1996 Act, the Commission must resolve to take no action that may distort LECs' market-based incentives to invest in advanced broadband networks or enter the video programming business.

Administratively prescribed allocations of joint costs will almost certainly distort financial incentives and corrupt the normal operation of markets. Comments that

support substantial allocations of joint costs to nonregulated activities completely ignore the potential effects of cost allocations on LECs' incentives to invest in broadband networks and to offer new services in competition with incumbents

The comments supporting fixed factors do no more than cast votes in favor of specific factors. A few drape their votes in the language of economics. None, however, claims that a fixed factor is not arbitrary. Some are arbitrarily picked out of the air. Some are arbitrarily calculated. None provides any evidence of the impact of its proposal on competitive entry or infrastructure deployment.

The Commission's authority to prescribe fixed factors is constrained by the requirement that its prescriptions not be arbitrary or capricious. Its decisions must be "supported by substantial evidence and based upon a consideration of the relevant factors" and must "have a rational connection to the facts found." To meet this standard, the Commission would have to justify the imposition of cost allocations, justify the use of a fixed factor and justify the specific fixed factor selected -- all in terms of the 1996 Act's public policy objectives. The record is devoid of substantial evidence to support any one of these required findings

Those who seek onerous new cost allocation requirements do so for one purpose -- to force reductions in LECs' rates from regulated services over and above what price cap regulation will produce. For AT&T and MCI, that result is a means to lower access charges and higher earnings. For the cable industry, that result is a means to impede LEC entry into the video programming business in competition with incumbents. LECs seek to avoid such rate reductions because they will act as financial penalties on decisions to invest in advanced broadband networks for use in the provision of regulated and nonregulated services

None of the parties proposing exogenous adjustments based on cost allocations demonstrates that such treatment would be consistent with "the underlying definition of exogenous costs, that they are incurred by means beyond the control of the carrier and that they are not otherwise accounted for in the price cap formula." They do not mention that price cap indices were established almost six years ago or that any connection between current rates and the costs underlying the rates on which the price cap indices were initialized in 1990 is virtually nonexistent Nor do they acknowledge that scope economies are already captured in the productivity offset so that an exogenous cost adjustment would double count this source of productivity.

The suggestion of some parties that telephone customers should be entitled to a benefit from LECs' investment in jointly used facilities is contrary to the well-established principles that the right to gains from a utility's assets is "tied to the risk of capital loss" and that "he who bears the financial burden of a particular utility activity should also reap the benefit resulting therefrom." This proceeding's goal of insulating telephone customers from the costs and risks of nonregulated activities is inconsistent with the suggestion that telephone customers are, nonetheless, entitled to share in economies resulting from investment to support such activities

The public, as telephone customers as users of video services, and as consumers in general, will benefit substantially from LECs' provision of video programming and deployment of integrated broadband networks Such benefits will accrue to consumers through the operation of competitive markets and the economic development resulting from the deployment of advanced telecommunications capabilities, as well as through the productivity adjustment in the Commission's price cap plan for LECs. There is no justification for imposing an additional benefit from economies of scope beyond that in the productivity adjustment

The Notice did not seek and the comments have not provided data by which the Commission can assess the effect of the various proposals on attaining of these goals of the 1996 Act. Indeed, the extraordinarily short comment and reply cycles, even with the extensions granted have not afforded the parties sufficient time to perform studies that would produce reliable projections of the effects of the various proposals. Allocation methods or factors resulting from such a course of action cannot avoid being arbitrary and capricious

More important than the legal inadequacy of this process is the clear prospect that ad hoc cost allocations will undermine the goals of the 1996 Act. Congress clearly intends for the Commission to promote competitive entry and infrastructure deployment. If the Commission uses contrived allocations of joint costs to adjust rates for regulated services, it will affect LECs' decisions about the introduction of competitive services and the deployment of advanced telecommunications capabilities. The Commission has not explored the key issues of competitive entry and infrastructure deployment as required by the public policy objectives of the 1996 Act. Without reliable data, the Commission cannot project what the negative effect will be and cannot know how its actions will affect the goals of the 1996 Act

Without further proceedings, the only way for the Commission to be assured that its actions will support competitive entry and infrastructure deployment is to avoid prescribing allocation methods and factors or requiring adjustments of regulated rates based on such allocations Existing price cap regulation makes it possible and reasonable for the Commission to take this approach without permitting cross-subsidy or exposing telephone customers to the risks of nonregulated ventures.

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To the Commission

Reply Comments

Notwithstanding the comments' many references to cross-subsidy, this proceeding has little to do with protecting telephone customers against cross-subsidy. Price cap regulation has already achieved that objective. Joint costs cannot be reduced by eliminating some of the individual activities supported by the joint costs. Thus, the failure of an individual activity to contribute proportionately, or at all, to the joint costs does not result in cross-subsidy.[2] Accordingly, allocation of joint costs is not necessary to prevent cross-subsidy.[3] The Notice implicitly acknowledges this fact when it attempts to justify allocation of joint costs as a means of assigning some benefit of

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[1] See Declaration of Dr. Larry F. Darby, attached hereto ¶11 ("Darby").

[2] LECs must, of course, receive enough revenues from all services to cover all costs, including joint costs, or they will not survive. Thus, LECs expect all products and services to produce sufficient revenues to cover their direct costs and make a contribution to joint costs. Managers that understand the nature of joint costs do not, however, arbitrarily allocate to individual services responsibility for a fixed portion of joint costs. Competitive businesses must recover joint costs in proportion to customers' willingness to pay for each service supported by those costs. See Darby, ¶10.

[3] The Commission has long acknowledged that full cost allocation is not necessary to prevent cross-subsidy and that its cost allocation rules attempt to achieve policy goals that "transcend prevention of cross-subsidy." Separation of Costs of Regulated Telephone Service from Cost of Nonregulated Activities, CC Docket No. 86-111, Report and Order, 2 FCC Rcd 1298, ¶109 (1987), *modified on recon.*, 2 FCC Rcd 6283 (1987), *modified on further recon.*, 3 FCC Rcd 6701 (1988), *aff'd sub nom. Southwestern Bell Corp. v. FCC*, 896 F.2d 1378 (D.C. Cir. 1990).

scope economies to telephone customers and of compensating for the imperfections of cost allocations.[4]

This proceeding fails to focus or seek comments on the potential impact of cost allocations on important public policies that the Commission is responsible for promoting: competitive entry and infrastructure deployment. If the Commission continues to approach this proceeding from the narrow perspective of regulatory accounting and allocation issues, it will risk doing substantial harm to consumers' interest in competitive entry and infrastructure deployment.[5]

Except for the LECs and a few others, the comments ignore these objectives of the Telecommunications Act of 1996 ("1996 Act").[6] Those comments advocate a regulatory regime for LECs in which accounting and allocation issues are central and larger policy goals are peripheral. For some parties, the goal of such a regime is reduction of access charges. For others, it is to deter LEC entry into the video programming business. Such parties focus on allocation techniques to further their private interests, but neglect the fundamental public policy issue. Having achieved a reasonable level of protection against cross-subsidy through price caps, should the Commission now adopt additional cost allocation requirements without regard for their potential to deter competitive entry and infrastructure investment by LECs?

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[4] Notice, ¶23.

[5] See Darby, ¶¶13, 20.

[6] Telecommunications Act of 1996, Pub. L. No. 104-104, 101 Stat. 56, Section 401, §10(a) (1996) ("1996 Act").

The 1996 Act requires the Commission to assess the potential for cost allocations to affect LECs' behavior in the market If cost allocations are administered to produce material reductions in revenues from existing services. LECs will avoid actions that give rise to cost allocations. When the decision faced is whether to risk large amounts of capital to become the latest entrant in markets dominated an incumbent providers, the financial margins are likely to be so thin that administrative reductions in existing revenues will determine the outcome [7]

LECs are facing difficult decisions regarding whether to invest their substantial, but finite, capital in advanced broadband networks or in other ventures. Even if risks are not increased by administrative cost allocations market conditions may make other investments more attractive Consistent with its obligations under the 1996 Act, the Commission must resolve to take no action in this docket that may distort LECs' market-based incentives to invest in advanced broadband networks or enter the video programming business.

I. Cost Allocation Rules Are Not Needed For Price Cap LECs.

The Commission has for almost six years regulated the prices of LECs by price caps -- a more elegant and effective means for preventing cross-subsidy and preserving market-based incentives than cost allocations can ever be.[8] Various parties assert that cost allocations continue to be necessary even under price caps.

[7] See Darby, ¶¶14-16

[8] See Darby, ¶11

Some refer to the continued existence of price cap plans with sharing mechanisms.[9] That presents no reason to impose cost allocation requirements on all LECs in all jurisdictions. Jurisdictions that maintain a cost-plus element to rate regulation are capable of enforcing whatever accounting requirements they deem necessary to serve their regulatory purposes. Moreover, even with sharing, price cap regulation makes the link between costs and rates so remote that expansion of current cost allocation requirements is would constitute excessive regulation.

Another reason given for continuing cost allocation rules is the current Universal Service Fund, which is "predicated on regulated cost levels."[10] This should be a short-lived problem. The Commission's pending rulemaking to implement Section 254 of the 1996 Act[11] can eliminate the continuing link between future accounting costs and the Universal Service Fund, as BellSouth has proposed. In the interim, it will be impossible for any LEC to invest enough in joint video and telephony facilities to affect Fund distributions. There is no threat to the public interest here.

The risk from eliminating cost allocation requirements for price cap LECs is minimal.[12] The risk of cross-subsidy by price cap LECs is so slight that, even if the Commission decides to retain cost allocation rules for the present, expansion of the

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[9] Florida PSC at 2; Sprint at 5.

[10] Florida PSC at 2.

[11] Federal-State Joint Board on Universal Service, *Notice of Proposed Rulemaking and Order Establishing Joint Board*, CC Docket No. 96-45, FCC 96-93 (rel. Mar. 8, 1996), ¶3.

[12] See Darby, ¶¶11, 20, 24.

cost allocation requirements would be without practical benefit. Where the Commission finds a risk to be minimal, it may decline to adopt rules to address that risk.[13]

II. Prescription Of A Fixed Factor Would Be Arbitrary And Capricious.

Because administratively prescribed allocations of joint costs are arbitrary,[14] they will almost certainly distort financial incentives and corrupt the normal operation of markets.[15] No party has claimed otherwise. Rather, comments that support substantial allocations of joint costs to nonregulated activities completely ignore the potential effects of cost allocations on LECs' incentives to invest in broadband networks and to offer new services in competition with incumbents.

None offers an economically based method for allocating costs that support regulated and nonregulated activities, because there is no such method.[16] None provides any data that would justify prescription of a fixed factor. The lack of data does not, however, restrain numerous parties from asserting that the Commission should prescribe fixed factors or from suggesting what those factors should be. Those comments do no more than cast votes in favor of specific factors. A few drape their votes in

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[13] See *Rural Telephone Coalition v. FCC*, 838 F.2d 1307, 1315 (D.C. Cir. 1988) ("Rural Telephone").

[14] Notice, n.19. See Darby, ¶10.

[15] See Darby, ¶¶13, 14.

[16] In a departure from the fixed factor advocated by other comments from the cable industry, Continental Cablevision, Inc., equates cost causation on hybrid fiber-coaxial cable ("HFC") networks with bandwidth utilization and asserts that the Commission must allocate joint costs on that basis (at 4-7). Continental asserts that video is the driver for deployment of HFC networks and therefore should bear most of the cost. This position is flawed for at least two reasons: (1) it ignores the nature of joint costs; and (2) it confuses cost causation on multipurpose networks with the events that trigger deployment. See Darby, ¶¶7-8, 22.

the language of economics. None, however, claims that a fixed factor is not arbitrary. Some are arbitrarily picked out of the air. Some are arbitrarily calculated. Most important, none provides any evidence of the impact its proposal would have on competitive entry or infrastructure deployment.

AT&T speaks glibly of "true economic costs," "uneconomic costs," and "the uneconomic loading of costs."[17] AT&T purports to base its proposal on an incremental cost study, the so-called "TSLRIC."[18] These trappings of economics may obscure, but cannot hide, the essential arbitrariness of the "methodology" proposed by AT&T.[19] An allocation is not based on economic principles simply because it uses the results of cost studies for the numerator and the denominator of the factor.[20] AT&T does not justify its methodology in relation to the important economic issues of this proceeding -- competitive entry and infrastructure deployment.

AT&T asserts that its approach is "simple to understand and apply," brings "certainty and fairness that promote the ability ... to compete effectively," and "is administratively manageable." From the perspective of an interexchange carrier, perhaps anything that contributes to access rate reductions is "fair." From the perspective of the Commission, however, fairness should mean eliminating regulatory disincentives to LECs' competitive entry and investment, particularly those that do not apply to their competitors.[21] Administrative simplicity is a false gain if an administrative

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[17] AT&T at 2-3.

[18] AT&T at 4.

[19] See Darby, ¶¶7-9.

[20] MCI makes the same logical error using stand-alone cost studies (at 8-10).

[21] See Darby, ¶19.

allocation distorts market incentives. The simplest course is to let markets allocate costs and rely on price caps to protect telephone customers.

NCTA, on the other hand, is forthright in nominating a 75 percent fixed factor without mathematical sleight of hand.[22] It does, however, seek to cloak its proposal in economic theory. It recommends that fixed factors be supplemented with a ceiling determined by "the stand-alone costs of a sophisticated telephone network."[23] NCTA fails to explain why a ceiling based on stand-alone costs provides any greater protection to telephone customers than existing price cap regulation. Both serve the same purpose: to ensure that costs that nonregulated activities add do not affect the prices for regulated telephone services or, in other words, that telephone customers pay the same price for telephone services with or without the firm's pursuit of the nonregulated activity. The difference is that price caps serve that purpose more efficiently and effectively by operating on the LECs' incentives and prices, rather than on their costs.[24]

Moreover, NCTA does not explain why an arbitrary fixed factor should be required in addition to stand-alone cost studies. NCTA shows little faith in the ability of its 75 percent allocation factor to prevent cross-subsidy.[25] Moreover, and most important, NCTA offers no information to help the Commission evaluate the potential impact

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[22] NCTA at 20-21.

[23] NCTA at 19. NCTA cites digital loop carrier networks as its example of a "state-of-the-art telephone system." Others might suggest fiber-to-the-curb, or fiber-to-the-home, or hybrid fiber/coaxial cable, given anticipated growth in demand for high-speed data services to residential customers. That NCTA's stand-alone cost analysis must be artificially limited to a narrowband technology calls into question its validity for cost allocation.

[24] See Darby, ¶¶8, 10.

[25] NCTA at 18.

of its fixed factor proposal on LECs' incentives to invest in advanced broadband networks and to compete against cable operators Notwithstanding NCTA's assertions regarding the economic basis of its position it focuses narrowly on accounting techniques and neglects the real economic issues -- investment and competitive entry in the video services market If the Commission follows this direction. will postpone competition for incumbent cable operators once again

The Commission's authority to prescribe fixed factors is constrained by the requirement that its prescriptions not be arbitrary or capricious Its decisions must be "supported by substantial evidence and based upon a consideration of the relevant factors" and must "have a rational connection to the facts found."[26] To meet this standard, the Commission would have to justify the imposition of cost allocations, justify the use of a fixed factor and justify the specific fixed factor selected -- all in terms of the 1996 Act's public policy objectives The record is devoid of substantial evidence to support any one of these required findings

III. Use Of Cost Allocations To Reduce LECs' Rates For Regulated Services Would Be Arbitrary And Capricious.

Those who seek onerous new cost allocation requirements do so for one purpose -- to force reductions in LECs' rates from regulated services over and above what price cap regulation will produce. For AT&T and MCI, that result is a means to lower access charges and higher earnings For the cable industry, that result is a means to impede LEC entry into the video programming business in competition with incumbents. LECs seek to avoid such rate reductions because they will act as financial

[26] *Rural Telephone*. 838 F.2d 1313.

penalties on decisions to invest in advanced broadband networks for use in the provision of regulated and nonregulated services

Several parties argue that cost reallocations under Part 64 resulting from the reclassification of existing plant from regulated to non-regulated should receive exogenous treatment in the LEC price cap plan None of those parties to demonstrates that such treatment would be consistent with "the underlying definition of exogenous costs. that they are incurred by means beyond the control of the carrier and that they are not otherwise accounted for in the price cap formula"[27] They do not mention that price cap indices were established almost six years ago or that any connection between current rates and the costs underlying the rates on which the price cap indices were initialized in 1990 is virtually nonexistent Nor do they acknowledge that scope economies are already captured in the productivity offset so that an exogenous cost adjustment would double count this source of productivity. BellSouth's Comments fully address these issues.[28]

IV. Conferring The Benefits Of Economies Of Scope Resulting From LECs' Investment Without Associated Risks Would Be Arbitrary, Capricious, And Contrary To The Law.

All parties agree that telephone customers should not bear the risks of LECs' pursuit of nonregulated businesses.[29] Nonetheless some comments assert a right for telephone customers to share in the benefits of the economies of scope resulting from LECs' nonregulated activities. There is no basis in law or economics for such a right.

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[27] Notice, n.68.

[28] See BellSouth Comments at 10 *et seq.*

[29] Notice, ¶25.

Aside from the potential exogenous treatment of investment reallocations discussed above, it is not clear what mechanism would be used to achieve such sharing. Are the parties suggesting an exogenous adjustment for new investment allocated to nonregulated activities? Such treatment is not required by current price cap rules and would represent a significant departure from the principles and objectives of price cap regulation.[30]

That telephone customers should be entitled to a benefit from investment for which they bear no risk is contrary to the well-established principles that the right to gains from a utility's assets is "tied to the risk of capital loss" and that "he who bears the financial burden of a particular utility activity should also reap the benefit resulting therefrom."[31] This proceeding's goal of insulating telephone customers from the costs and risks of nonregulated activities[32] is inconsistent with the suggestion that telephone customers are entitled to share in economies resulting from such activities.

Under price cap regulation (even with sharing), LECs' shareholders unambiguously bear the risk of loss of all investment whether used to provide regulated or nonregulated services.[33] If LECs invest in integrated facilities and equipment that enable them to provide regulated and nonregulated services more efficiently than they could provide those services over separate facilities, on what basis may the Commission assign a share of the financial benefit but none of the risk, of that

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[30] See BellSouth Comments at 11-12.

[31] *Democratic Cent. Com. of D.C. v. Washington M.A.T Com'n.* 485 F.2d 786, 806 (1973).

[32] Notice, ¶24.

[33] See Darby, ¶15.

investment to customers? To do so would be unlawful and would not serve the public's interest in promoting competitive entry and infrastructure deployment

Some parties assert that telephone customers have a right to be compensated for nonregulated uses of LEC's facilities because the "facilities have been paid for by customers of regulated services . . . ."[34] This assertion is contrary to established law. The economic relationship between public utilities and their customers was enunciated by the United States Supreme Court many years ago

> Customers pay for service, not for the property used to render it. Their payments are not contributions to depreciation or other operating expenses or to capital of the company. By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company just as does that purchased out of proceeds of its bonds and stock.[35]

This affirmation of the property rights of utilities was made in the context of a rate-of-return proceeding. It leaves no room for the notion that LECs' plant is acquired with "ratepayers' money" or that telephone customers have a right to any benefit from a telephone company's property other than to receive the service they pay for.

The public as telephone customers as users of video services, and as consumers in general, will benefit substantially from LECs' entry into the provision of video programming and from LECs' deployment of integrated broadband networks. Such benefits will accrue to consumers through the operation of competitive markets and the economic development resulting from the deployment of advanced telecommunications

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[34] Time Warner at 3; Comcast at 9.

[35] *Board of Pub. Util. Comm'rs v. New York Tel. Co.*, 271 U.S. 23, 31-32 (1926).

capabilities, as well as through the productivity adjustment in the Commission's price cap plan for LECs. There is no justification for imposing an additional benefit from economies of scope beyond the productivity adjustment, which maintains downward pressure on the real price for regulated telephone services to ensure that regulated prices remain just and reasonable.

V. Assertions That Telephone Customers Are Burdened With Excess Spare Capacity Are Wrong.

Some comments look at LECs' reported levels of spare fiber and conclude that LECs have deployed excess fiber to prepare for entry into the video business. These assertions are wrong. BellSouth's reported levels of spare fiber are the result of its forecasts of demand for communications services and its engineering analysis of the relative economic benefits of achieving required levels of capacity by deploying larger amounts in a single project compared to deploying lesser amounts in multiple projects. The economic trade-offs are well understood in the industry and in the business community at large. The incremental cost of added capacity in an initial project is substantially less than the cost of undertaking a second project, but after some period the time value of money eliminates the cost advantage and warrants waiting until later to place the additional capacity. This process produces substantial amounts of economically deployed spare fiber, but does not produce excess capacity. Under rate-of-return regulation, this process lowered the costs of facilities and thus produced lower rates to telephone customers. Under price cap regulation, the process has no impact on rates for telephone service. BellSouth's telephone customers bear no rate burden because of any spare capacity placed for nonregulated uses.

VI. Reduction Of Telephone Rates To Reflect Imputed Pole Attachment Charges Would Be Inconsistent With Price Cap Rules.

Grasping at every opportunity to penalize LECs for intruding into the cable business, NCTA urges the Commission to reduce telephone rates to reflect the imputation of pole attachment charges under Section 224(g) of the 1996 Act.[36] NCTA is careful not to claim that Section 224(g) requires such reductions, because it clearly does not. Such reductions would amount to a new kind of exogenous adjustment under price caps. The Commission has made it clear that exogenous cost adjustments were not intended to be permanent, much less to be augmented as suggested by NCTA.[37]

VII. Conclusion

The Notice is vague about the results it intends to achieve.[38] It mentions the goals of the 1996 Act,[39] but it does not analyze the various alternatives in terms of their effect on achieving those goals.[40] The Notice does not seek and the comments have not provided data by which the Commission can assess the effect of the various proposals on attaining of those goals. The extraordinarily short comment and reply cycles, even with the extensions granted, have not afforded the parties sufficient time to perform studies that would produce reliable projections of the effects of the various proposals. Thus, the Commission proposes to adopt some arbitrary method or factor for allocating joint costs without data regarding the probable effects on the goals of the

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[36] NCTA at 22-23.

[37] See BellSouth Comments at 11-12.

[38] Notice, ¶¶22 *et seq.* See Darby, ¶¶3-4.

[39] Notice, ¶22.

[40] See Darby, ¶17.

1996 Act. Allocation methods or factors resulting from such a course of action cannot avoid being arbitrary and capricious.[41]

More important than the legal inadequacy of this process is the clear prospect that ad hoc cost allocations will undermine the goals of the 1996 Act. Congress clearly intends for the Commission to promote competitive entry and infrastructure deployment.[42] If the Commission uses contrived allocations of joint costs to adjust rates for regulated services, it will affect LECs' decisions about the introduction of competitive services and the deployment of advanced telecommunications capabilities.[43] The Commission has not explored the key issues of competitive entry and infrastructure deployment as required by the public policy objectives of the 1996 Act. Without reliable data, the Commission cannot project what the negative effect will be and cannot know how its actions will affect the goals of the 1996 Act.

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[41] See Darby, ¶23.

[42] See Darby, ¶13.

[43] See Darby, ¶19.

Without further proceedings, the only way for the Commission to be assured that its actions will support competitive entry and infrastructure deployment is to avoid prescribing allocation methods and factors or requiring adjustments of regulated rates based on such allocations. Existing price cap regulation makes it possible and reasonable for the Commission to take this approach without permitting cross-subsidy or exposing telephone customers to the risks of nonregulated ventures.[44]

Respectfully submitted,

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[44] See Darby, ¶24.

Larry F. Darby is an economic and financial consultant based in Washington, DC. He earned a doctorate in economics from Indiana University in 1971, specializing in industrial organization and international economics. He subsequently joined the faculty of the Graduate School of Business at Temple University, where he taught managerial and industrial economics and regulation of business.

In 1975 he became Senior Economist in the White House Office of Telecommunications Policy. He subsequently served as Chief Economist and Chief of the FCC's Common Carrier Bureau where he was the architect of Commission orders directing reorganization and reregulation of the telephone industry, satellite businesses, and the telephone equipment sector -- from lowering entry barriers to prescribing market-competitive ratemaking and accounting practices.

After leaving the FCC, and spending two years on Capitol Hill directing a joint Congressional investigation of application of the antitrust laws to the motor carrier industry (Executive Director of the Motor Carrier Ratemaking Study Commission), he went to Wall Street in 1983 to join Lehman Brothers where he was Vice-President in the Telecommunications Investment Banking group

At Lehman he concentrated on asset valuations; in particular, assessment of the impacts on financial values of technological, regulatory and market developments affecting cable television, broadcasting and telecommunications (services and equipment) companies. He also engaged in a variety of project finance transactions requiring valuation of unique and specialized assets (satellite systems, undersea cables, and others).

In 1988 Dr. Darby returned to Washington, D.C. and founded Darby Associates, Communications Consultants. Since then, he has advised a broad spectrum of clients on issues related to broadcasting, cable television, domestic and foreign telephony, trade and technology, and domestic common carrier regulation. Recent consulting assignments required assessments of : the financial effects and investment impacts of alternative regulatory schemes in telephony; quantitative relations between telecom and cable television regulation and national macroeconomic performance (income, growth, productivity and jobs); several matters related to tariffs for interstate access to local telephone networks; the economics of multimedia market development; markets for digital broadcasting services; estimation of spectrum auctions proceeds; PCS license values; business case for electric utility provision of information services; technoeconomic assessment of international broadcasting opportunities; markets for new satellite and Internet applications; and, radio broadcast license valuations.

He is a Lecturer in Telecommunications Finance at the George Washington University Graduate School in Washington, D.C.; writes a biweekly column (Investment Notes) for Communications Business and Finance; and, is a frequent participant in professional conferences on matters related to economic impacts of telecom technology advances and regulatory reform He was recently invited to testify before the Senate Commerce Committee on issues related to spectrum auctions. He is Senior Economic Advisor to CompassRose International, Inc. and is writing a book on regulatory reform and telecom capital formation in the U.S.

Declaration of Dr. Larry F. Darby

1. My name is Larry F. Darby. I am an economic and financial analyst specializing for the past twenty years in matters related to the evolution of telecommunications technology, markets and public policy. I head Darby Associates, a consulting practice in Washington, DC. I am Professorial Lecturer in Telecommunications Finance at the George Washington University Graduate School and contributing editor to Communications, Business and Finance for which I write biweekly articles under the banner, "Investment Notes". I have previously served as Assistant Professor of Economics -- Graduate School of Business, Temple University; Senior Economist in the White House Office of Telecommunications Policy; Chief Economist and Chief of the Federal Communications Commission Common Carrier Bureau; and, Vice-President of Corporate Finance in Lehman Brothers Telecommunications Investment Banking Group. I earned a PhD in Economics from Indiana University. My professional interests and activities are focussed on the intersection of telecommunications network economics, finance and public policy.

2. I have been asked by the BellSouth Corporation to analyze and clarify some matters raised in the Commission's Notice of Proposed Rulemaking in Docket 96-112. My principal conclusions are:

- The Commission's policy objectives ought to be fully and explicitly expressed in order to assure that rules adopted here serve the statutory goals of the new Telecommunications Act;
- "Cost causation" in the current telecommunications environment cannot be established and is void of economic content as a cost allocator;
- Usage as an allocator of nontraffic sensitive costs is arbitrary and bears no relation to economic efficiency;
- All ex-ante cost allocations are essentially arbitrary. Depending on how they Commission requires cost allocation to be used, they contribute to nonmarket

based prices, lead to uneconomic allocations of market share among competitors and, result in distorted, nonmarket-based investment and resource allocation decisions;

- Administrative cost allocation is not needed under price cap regulation to guard against subsidy of competitive services by monopoly network services or to insulate ratepayers from risks of unregulated ventures;
- Protecting competitors will lessen market incentives and the rate of development of broadband networks, while denying the public the benefits of competitive market discipline in both regulated and unregulated markets;
- The Commission should trust competitive forces and permit the marketplace to determine, as it does in the rest of the economy, how and from what goods and services, common costs will be recovered.

3. *What are the key public policy goals to be achieved by the rules established in this proceeding?* The purposes of Congress in respect of video services markets are clearly set forth in the Telecommunications Act of 1996. Overall, Congress charged the Commission "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced technologies and services to all Americans by opening all markets to competition...." More particularly, in video services markets, Congress placed a high priority on a) promoting competition in video program delivery systems, b) encouraging investment in new technologies and infrastructure, c) streamlining regulation d) maximizing consumer choice of information and entertainment services, and e) ensuring program diversity.

Congress emphasized that vigorously competitive video markets are the best way to serve consumers' interests and made clear its intention for the Commission quickly to fashion a set of regulations to encourage local exchange companies "to enter and compete in the video marketplace".